CONTENTS

CEO's Foreword – Mark O'Hare 3

1. 2019 PREQIN GLOBAL PRIVATE DEBT REPORT
Private Debt: Preparing for the Unknown 6
– Ross Ellis, SEI Investment Manager Services
Key Trends of 2018 8

2. FUNDRAISING IN 2018
The Challenges of Private Debt Fundraising 10
Fundraising in 2018 12
Regional Fundraising 14
Funds in Market 16

3. FUND MANAGERS & AUM
The Investment Case for African Private Debt 18
– Todd Micklethwaite, Sanlam Investments
Onwards and Upwards for Private Debt 20
Assets under Management 22
Fund Managers 24

4. INVESTORS
The Private Credit Industry in 2018 – Jiří Król, Alternative Investment Management Association (AIMA) 26
Investors Continue to Be Drawn to Private Debt 28
Investors 29
Future Investments 30

5. PERFORMANCE
Vast Opportunities in Chinese NPLs 32
– Xiaolin Zhang and Zheng Zhang, Lakeshore Capital
Private Debt Delivering for Investors 34
Performance Overview 36

6. DEALS
The Importance of the Lender Borrower Relationship – Andre Hakkak, White Oak Global Advisors 40
Deal Competition Leading to a Challenging Market 42
Deals 44

7. OUTLOOK
Investors Sticking with Private Debt in 2019 48
Outlook for Private Debt 50

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PRIVATE DEBT REMAINS A STEADY ASSET CLASS FOR INVESTORS, OFFERING DOWNSIDE PROTECTION AMID TURBULENT MARKET VOLATILITY. ASSETS UNDER MANAGEMENT (AUM) CONTINUE TO GROW, REACHING RECORD LEVELS ONCE AGAIN AS INVESTORS ARE DRAWN TO THE ASSET CLASS FOR ITS DIVERSIFICATION AND FAVOURABLE RISK-ADJUSTED RETURNS.

**STRONG FUNDRAISING CONTINUES**

$110bn in aggregate capital was raised in 2018, following a record $129bn secured in 2017

41% of total capital raised in 2018 was secured by direct lending funds

**AUM REACHES RECORD LEVELS**

$769bn AUM as at June 2018, a record

$109bn Direct lending dry powder as at June 2018

92% of surveyed fund managers expect AUM to increase in 2019

**CAPITAL INVESTMENT INCREASING**

$755mn Average size of private debt funds closed in 2018

80% of surveyed investors expect to invest more capital in private debt in the next 12 months compared with the previous 12 months

**INVESTORS SATISFIED WITH PRIVATE DEBT**

$134bn was distributed in 2017

Investors invest in private debt for diversification, high risk-adjusted returns and a reliable income stream

91% of surveyed investors felt private debt met or exceeded performance expectations in 2018

**COMPETITION A CONCERN**

$307bn Total industry dry powder available as at June 2018, a record level

53% of surveyed fund managers cite competition as the biggest challenge facing return generation in 2019

**UNCERTAINTY AROUND INTEREST RATES**

1st Rising interest rates were identified as a key concern for the year ahead by 50% of surveyed investors

5th Just 22% of surveyed fund managers named rising interest rates as a key challenge for 2019, ranking it fifth overall
The prodigious growth of private debt in recent years has been extensively documented. Growing competitive pressures and macroeconomic changes are now leading to more scrutiny of the risks that may accompany this growth. Rates are rising, volatility is increasing, and the global economy appears unsettled by the sacrifice of free trade on the altar of populist politics. The US Federal Reserve recently flagged the private debt market as a potential threat to financial stability. Another red flag is the growing perception that too much capital is chasing too few deals, a trend that may force some GPs towards lesser-quality deals and lower returns. The sheer rate of growth and the rush of new participants are reminiscent of other investments prior to experiencing corrections.

In a market full of promise yet fraught with risk, what is the best way forward? As concerns mount, SEI collaborated with Preqin to survey and interview more than 200 private debt managers and investors in order to discern how GPs might best weather the impending slowdown. Our findings suggest a number of important considerations for managers wishing to take advantage of the opportunities in private debt. These range from niche lending strategies and customized portfolios to the use of advanced data analytics and a greater emphasis on operational efficiency and resilience.

FORCES OF CHANGE
Investors and fund managers do not always share the same perspectives. LPs, for example, are more likely to say that advanced data analytics will have a noticeable effect, with half of them saying that advancements in analytics will spur the development of more customized investment vehicles. Even more think data analytics will soon permit more types of investors to participate in the private debt market. The most likely impact, though, is better integration of alternative data into the evaluation of credit quality.

Almost one out of three investors we surveyed say one notable feature of the fintech landscape, peer-to-peer lending platforms, is a disruptive phenomenon that could displace some traditional funds in the private debt market. Most managers, on the other hand, dismiss such a scenario. Only time will tell which perspective is correct.

Deal flow is expected to shift away from private equity-driven M&A activity towards middle-market borrowers that are not backed by sponsors. Investors think some of this demand may be met by banks as they re-enter the market, invigorated by deregulation and rising rates. Managers are more sanguine, with two out of three opining that banks are unlikely to re-enter the market at a scale sufficient to meaningfully reshape the landscape.

With a growing percentage of assets locked up by a small group of mega-lenders, today’s private debt market gives every indication of being a stable and orderly corner of the asset management world. But potentially disruptive technology is knocking at the door. Traditional lenders in the form of banks remain on the sidelines. Thousands of hedge funds are launching lending products. Will all of these parties be able to co-exist? Will innovation flip the script? Where are the opportunities for managers in a market that is becoming undeniably more competitive?

OPPORTUNITIES FOR MANAGERS
Asset managers in the current climate are forced to tackle what might be called “the specialization paradox.” On the one hand, many would rather
not be narrowly labelled, preferring to be seen as vehicle-agnostic asset managers that offer their expertise packaged in a variety of ways. The allure of this approach is enhanced by the fact that it provides some degree of protection against the vagaries of performance and market demand. On the other hand, investors and intermediaries need to categorize managers, which are also faced with growing competitive pressure to stake their claim in a particular area of expertise.

With industry giants dominating the so-called sweet spot of $20-50mn loans, any new player must aim to occupy a specific niche. Specialization can take many forms. It might refer to geographic expertise in a market such as India. Alternatively, it can reflect deep knowledge of the arcane details found in something like the aircraft leasing business. In any case, traditional specialization is increasingly joined by even more niche strategies as managers move away from direct lending and explore deals featuring non-traditional assets such as royalty streams.

Customization is another way to stand out in the crowd. Investors are eager to find the perfect fit for their needs, whether this means dialling in a specific income stream or applying an ESG screen with certain criteria. Managers that can accommodate such requests are better positioned to win their business. Customized portfolios will never completely replace pooled products, but as long as they can be efficiently managed without adversely affecting the investment process, they are likely to become more popular.

As deal flow becomes more challenging, more firms are likely to leverage technology to help find, vet, negotiate and value opportunities. Investors in private markets are already accustomed to finding and scrutinizing unusual and hard-to-find data, but managers that leverage advanced technology may be able to leapfrog the competition. Fewer than one in 10 fund managers, for example, currently uses artificial intelligence (AI) or machine learning processes, but they will be joined by another one in four over the coming five years. It is not hard to imagine this number going up as the cost of machine learning tools continues to drop and benefits become more apparent.

Technology can also be harnessed to optimize operational processes. Given the pervasive sense that the current cycle is due for a correction, any additional resilience afforded by operational efficiency and cost control becomes even more important. Firms are already finding that it is possible to automate processes where automation once seemed impossible. Service providers and other third-party vendors with up-to-date knowledge of operational best practices are available to help, and multi-asset managers in particular can find it beneficial to work with providers that have expertise and experience in all asset classes.

**PREPARING FOR THE UNKNOWN**

Leaving aside the precise timing of the next correction, the maturation of the asset class means private debt managers will need to focus more on expense management and productivity than they have previously. Competitive firms will be those that proactively leverage the transformative potential of technology. Investment ideas, product customization, investor reporting, operational efficiency, portfolio integration and security can all be improved.

Specialist knowledge and operational excellence are paramount. An array of technology vendors and service providers already empower managers and investors throughout the asset management industry in their quest for these two objectives. The successful manager will be the one that collaborates most effectively, combining internal expertise with external resources to create an innovative team capable of adapting to changing circumstances and executing a distinctive and resilient strategy designed to survive and thrive in all market conditions.

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THE CHALLENGES OF PRIVATE DEBT FUNDRAISING

In 2018, $110bn was secured in aggregate capital commitments, a positive sign for the industry despite the full-year total not matching 2017’s record. This is good news for businesses and firms seeking to borrow from non-bank lenders, with competition for deals ensuring a healthy environment for negotiating attractive terms. However, while investor sentiment remains positive, the influence of large, brand-name fund managers and the volume of competitive noise in the market will pose a challenge for smaller and emerging managers seeking to attract capital in 2019.

INCREASED CAPITAL SHARE FOR MEZZANINE
Direct lending continues to dominate the fundraising market, capturing 41% of capital secured by funds closed in 2018 (Fig. 2.2). Mezzanine funds, though, have attracted substantial interest, with their share of aggregate capital raised increasing from 10% in 2017 to 28% in 2018, largely attributed to Goldman Sachs closing its GS Mezzanine Partners VII fund on $13bn. Special situations funds accounted for 10% of capital raised in the year. Geographically, funds focused on North America accounted for 62% of vehicles closed in 2018, similar to levels seen in recent years (Fig. 2.3). Europe’s share declined slightly to 33%, while funds focusing on Asia & Rest of World represented only 4% of those closed in the year. More so than in previous years, different fund types were dominant across the different regions: mezzanine and direct lending funds accounted for the largest proportions of North America-focused capital raised in 2018, direct lending funds secured the most capital in Europe and special situations funds took the largest share in Asia.

INVESTORS PRIORITIZE EXPERIENCE
There is evidence that shifting market conditions in 2018 have already influenced the investment activity of institutional investors. Although more capital was committed to the largest fund managers in 2018 than ever before, the proportion of capital secured by first-time fund managers dropped to an all-time low of 6% (Fig. 2.7), suggesting that investors are choosing to back fund managers with a proven track record, perhaps prioritizing those with experience investing through a market downturn.

MORE FUNDS ENTERING THE MARKET
While the overall rate of fundraising has slowed both in terms of capital and, more noticeably, the number of funds, the pace at which new vehicles are entering the market has not. Aggregate capital raised in 2018 was down 15% compared with 2017; in contrast, the aggregate amount targeted by funds in market at the start of 2019 is up by 13% from one year ago, with the number of vehicles on the road also up by a sizeable 18%.

For investors, a large supply of vehicles in market is a positive situation – but with so many funds seeking investment, fund selection and due diligence is set to become significantly more demanding. This is especially true for institutions where the allocation to private debt is shared with other private capital fund types that are all seeing a similar increase on the supply side. In order to select the best funds for their desired strategy, investors need to carefully consider the precise area of the market to which they want to gain exposure and to conduct due diligence using robust market data and the relevant tools.

POSITIVE SIGNS FOR MANAGERS
For fund managers, it is important to consider the current market environment and the drivers behind recent investor activity – specifically, why have investors favoured more experienced managers and larger funds over the course of 2018 more so than in previous years? One factor, especially considering market conditions and the relative youth of the asset class, is that managers with demonstrable experience in restructurings, workouts or weathering past periods of turmoil are pitching a compelling story that resonates with investors in times of uncertainty. Equally important is that experienced managers have an established network of connections which can assist in driving deal flow,
Fig. 4.1: Institutional Investors in Private Debt by Type

- Private Sector: 16%
- Pension Fund: 13%
- Public Pension Fund: 12%
- Family Office: 9%
- Endowment Plan: 9%
- Insurance Company: 9%
- Wealth Manager: 7%
- Asset Manager: 6%
- Bank/Investment: 5%
- Fund of Funds: 5%
- Other: 9%

Source: Preqin Pro

Fig. 4.2: Institutional Investors in Private Debt by Location

- North America: 25%
- Europe: 56%
- Asia: 13%
- Rest of World: 6%

Source: Preqin Pro

"The future impressions of borrowers, investors and policymakers towards private credit will likely be influenced by the industry’s performance through what are set to be more challenging economic conditions in the years ahead."

Jiří Król, Alternative Investment Management Association

Fig. 4.3: Investors’ Median Current and Target Allocations (As a % of Total AUM) to Private Debt by Type

- Asset Manager: Median Current Allocation 2.0%, Median Target Allocation 3.0%
- Endowment Plan: Median Current Allocation 2.5%, Median Target Allocation 5.0%
- Family Office: Median Current Allocation 5.0%, Median Target Allocation 6.5%
- Foundation: Median Current Allocation 1.9%, Median Target Allocation 3.0%
- Insurance Company: Median Current Allocation 1.0%, Median Target Allocation 1.7%
- Private Sector Pension Fund: Median Current Allocation 2.0%, Median Target Allocation 5.0%
- Public Pension Fund: Median Current Allocation 2.2%, Median Target Allocation 5.0%
- Sovereign Wealth Fund: Median Current Allocation 1.0%, Median Target Allocation 5.0%
- Supranational Scheme: Median Current Allocation 8.3%
- Wealth Manager: Median Current Allocation 5.0%

Source: Preqin Pro
7. OUTLOOK

Fig. 7.4: Fund Types that Investors View as Presenting the Best Opportunities, 2017 vs. 2018

Fig. 7.5: Investor Views on Portfolio Company/Asset Pricing Compared with 12 Months Ago

Fig. 7.6: Amount of Capital Fund Managers Expect to Deploy in the Next 12 Months Compared to the Previous 12 Months

Fig. 7.7: Investors’ Intentions for Their Private Debt Allocations over the Longer Term, 2017 vs. 2018

92% of surveyed fund managers expect private debt assets under management to increase over 2019.
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